



# Maryland State Treasurer's Office



Nancy K. Kopp  
• Treasurer

## Senate Budget and Taxation Committee

### Education, Business and Administration Subcommittee

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### Testimony of State Treasurer Nancy K. Kopp

Good afternoon, Chairman Hogan, and members of the committee. I am pleased to appear before you today to present the State Treasurer's Office's proposed budget for 2007 and to respond to the issues raised by the Department of Legislative Services.

Before I address the analyst's specific recommendations, I would like to update you briefly on a few of the significant accomplishments of the Treasurer's Office during the past year. It has been a very good year, one in which we, with your support, have made a number of accomplishments with which I trust you will be pleased.

**Investment** - The size of the General Fund investment portfolio since the beginning of FY 2006 averaged \$6,176,567,799 as of January 31, 2006. This represents an increase of more than \$1.4 billion over the average of \$4,740,266,653 for the same period in FY 2005. Much of this was due to an increase in State revenue to be invested, as well as to an increase in short-term interest rates.

On January 31, 2006, the portfolio was earning an average of 4.18%, compared to 2.35% at the same time last year. The rise in interest rates resulted in gross interest earnings, before interest allocation to State agencies, of \$127,436,798 year-to-date in FY 2006 compared with earnings of \$48,553,693 for the same seven-month period for FY 2005. This 162% increase added \$40.6 million to the State's coffers.

Interest rates had declined from the beginning of calendar year 2001 through May 2004. Throughout FY 2004 rates traded in a very narrow range of only 17 basis points, from 1.36% to 1.19%. In June 2004, however, portfolio interest rates started moving up from 1.27%; and by the end of January 2006, portfolio rates had increased 291 basis points to 4.18%.

**Finance** - Maryland is one of only six states to have the highest possible rating of AAA from all three bond rating agencies. Moody's, Fitch and Standard and Poor's have recognized Maryland for its sound financial management, including the policies to keep debt within affordability limits, and for our diversified and strong economy.

As a result of these exceptional ratings and the strong demand in the market for Maryland bonds, the Treasurer's office completed two successful bond sales in 2005.

- The first sale of \$656,185,000 in General Obligation Bonds on March 2, 2005, included \$350,000,000 of tax-exempt bonds for capital improvements, \$281,185,000 in refunding bonds and \$25,000,000 in taxable bonds. As a result of the refunding, interest savings of approximately \$11.9 million were realized. The State also received \$60.5 million in premiums as a result of this sale; \$28.4 million was used to redeem higher rate bonds, \$1.1 million was used to pay for the costs of issuance and \$31.0 million was deposited into the bond annuity fund to pay future bond interest. The interest rate was 3.673% for the tax-exempt bonds and 3.920% for the taxable bonds.
- On July 20, 2005, the second sale of \$450,000,000 was completed. It was comprised of \$430,000,000 of tax-exempt bonds and \$20,000,000 of taxable bonds. The interest rate was 3.804% for the tax-exempt bonds and 4.426% for the taxable bonds. The bonds were sold with a premium of \$33.8 million; \$.8 million was used to pay for the costs of issuance and \$33.0 million was deposited into the bond annuity fund to pay future bond interest.
- On Wednesday, March 1, 2006, we plan to sell \$300,000,000 of General Obligation Bonds consisting of \$280,000,000 of tax-exempt bonds and \$20,000,000 of taxable bonds.
- Since March, 2002 the State has realized additional revenue in premiums on our bond sales of \$240.842 million and present value savings on refundings of \$65.2 million

The Office also solicited proposals for and entered into a 15-year capital lease-financing of the acquisition by Morgan State University of certain improved real property near the University's campus. This unique transaction allowed Morgan State University to take advantage of an unanticipated opportunity to acquire 2.2 acres of improved property for \$2.225 million at a favorable rate of 4.28%.

**Insurance** – We continue to make progress in finding ways to do business more efficiently and save costs. For instance, we will continue to spend \$50,000 for engineering surveys because the expenditure has provided an immediate return in the form of a \$250,000 reduction in the property policy premium and important supplemental loss prevention technical information.

Our Risk Manager has conducted personal visits to many State agencies to assess current risk management practices and has recommended areas of loss improvement. With continued site visits we hope to reduce large losses in the State Insurance Trust Fund by identifying loss trends, reviewing our findings with State agencies, consulting with risk managers in State agencies, and evaluating safety programs and implementing changes.

Over the past year, the claims unit successfully reduced its open claims inventory by nearly 40%. The reduction was accomplished through a unit restructuring and a renewed focus on reviewing and closing inactive claims. Management also increased the number of internal file audits and daily claim reviews to further enhance work quality and reduce claim cycle time.

In the past 6 months, three adjusters enrolled in insurance courses offered through the Insurance Institute of America and the Chartered Property Casualty Underwriting Program. These skill enhancements will improve the department's functional knowledge and provide individual job enrichment opportunities.

**Information Technology** - We have strengthened our IT processing and procedures over the last year. We successfully migrated off of our old AS/400 systems over to new IBM i5 systems. This migration was necessary since the existing AS/400 computer system was operating at high risk of hardware failure. A failure would have put at risk the processing of daily disbursements that range from \$100 million to \$1 billion per day. A new production system provided the Treasurer's Office with more storage and a faster processor. One example of the improvement is the faster processing of the State's Vendor Payments file from 50 minutes down to 8 minutes.

The system migration provided the Treasurer's Office with an improved test system. The new test system allows the Treasurer's Office to meet industry audit standards and correct audit deficiencies that were cited in the most recent legislative audit. The test system is now large enough to do a full load test of program changes prior to their release to the production system. The test system is also able to serve as a contingent system if a production system outage were to occur.

The Office has also reached an agreement with our current maintenance vendor to provide the Treasurer's Office with a contingency site and hardware in the event of a disaster. We are working with the Comptroller's ADC to install and migrate over to newly purchased communications software that meets their standards. The software transmits the data over the much faster State network in place of slower data lines. The software provides more security by offering data files to be encrypted for transmissions to ADC as well as to our banks. The new software will also permit the Treasurer's Office to send and receive data with ADC in the event of a contingency disaster being declared.

The Treasurer's Office efforts over the past year demonstrate our commitment to following the State's standards and providing our services in the most efficient and effective manner possible.

As you might imagine, I'm quite proud of our recent accomplishments and feel confident that we will have even more to report next year.

### **Response to Legislative Analyst's Issues and Recommendations:**

- 1) DLS recommends that the Treasurer brief the committees on the new banking reconciliation procedures and processes that intended to ensure that such a situation does not repeat itself.***

The cash reconciliation remains the main focus of the Banking Division. Since the last budget hearing, timely audit sign off on the cash reconciliation for the FY 2005 Comprehensive Annual Fiscal Report (CAFR) was achieved. Currently, our daily reconciliations are being completed within 5 days, well ahead of our FY 2006 goal. *I am also pleased to tell you that the Banking Services Division has identified and reconciled all transactions for every day in FY 2006 to date.*

The Banking Division's efforts over the past two years have resulted in an entirely revised, restructured, and accurate daily reconciliation process which incorporates new reports and reporting mechanisms and better documented accounting procedures. All reconciliation elements are supported with detailed documentation. Existing functions had to be analyzed and re-engineered. Comprehensive and strict processing and accounting controls were added to these existing functions which had a direct impact on the ability to develop an accurate reconciliation. Several of these included:

- Establishing a daily reconciliation as the only way to accurately monitor the State's banking activity, providing the ability to quickly identify and respond to any processing irregularities.
- Developing and implementing an ACH tracking schedule to ensure properly recorded activity from bank to general ledger. This enhanced control uncovered numerous discrepancies in the ACH posting process.
- Developing and implementing manual wire activity reconciliation which captures daily manual wire activity from the bank statement, records processed and unprocessed transactions, and updates the unprocessed outstanding balance used in the bank reconciliation.
- Developing and implementing a system to track all bank activity and to categorize this data into specific operating components.

Numerous other financial and operational controls were added to existing functions to ensure the continuity of an accurate, documented, and auditable reconciliation. Banking Services will continue to enhance existing internal processes and work with the State agencies to strengthen and develop their internal processes to maintain our goal of providing efficient, accurate, and timely banking services to all State agencies and external customers.

During our exhaustive process of reconciling the State's cash positions, we found several functions within the Banking Division that had never been done and are critical to achieving an accurate reconciliation. These functions must continue if the State wants to maintain the new, restructured, and fully documented daily reconciliation process now in place. Some of these daily functions include the reconciliation of the community bank accounts, reconciliation of bank files and analysis to ensure data integrity, reconciliation and clearing of unmatched deposits, and interfacing with State agencies to address deposit, ACH, and adjustment issues. A brief description of these functions follows.

- Community banks are used as depositories by State agencies that are not in proximity to a branch of our contracted depository bank. Collected balances are subsequently transferred by the agencies via ACH transactions to our main depository account. This daily process requires numerous detailed tracking schedules and reconciliations to ensure funds are transferred properly and are recorded accurately on the State's general ledger. This process accounts for approximately \$300 million in annual receipts and requires a minimum of 1.5 full time staff.
- The Treasurer's Office receives numerous transaction and data files from banks, State agencies, and the State's general ledger system. It is imperative that these files be reconciled to our bank statements and analyzed to ensure data integrity, a daily process previously not performed and one that identified numerous data discrepancies. This process requires 1.0 full time staff.
- State agencies deposit cash and checks in the bank as well as record these deposits in the State's general ledger. It is the responsibility of the Treasurer's Office to ensure bank deposits equal book deposits. We have developed an accurate, documented, daily deposit match procedure to strictly

control this process. Accurate outstanding deposit totals are critical to precise cash reconciliation. This function requires a minimum of 2.0 full time staff and, along with this deposit match process, includes bank adjustment research and processing.

To maintain the daily reconciliation process now in place, we have requested four additional PINS in the FY 07 budget. As you are aware, to complete the bank reconciliation project we received a deficiency appropriation of approximately \$1 million which was expended for approximately 11 temporary accounting employees and 5 IT programmers, most of whom are now gone. We currently have on staff 4 remaining contractors who are continuing to perform the functions necessary to maintain the daily reconciliation.

The analyst is recommending the deletion of the PINS and funding citing that the low salary level for these positions will make them difficult to fill. While we agree with the analyst that the salaries are, in fact, below our needs, ***the positions themselves are absolutely essential if the State wants to maintain the reformed reconciliation process and structure currently in place.***

***Furthermore, the Treasurer should brief the committees on the timetable and estimated costs for the planned implementation of a new automated banking reconciliation system.***

The automation of the bank reconciliation was put on hold at the beginning of our project as it became obvious that a thorough understanding of all the banking data and processes was lacking. As we have worked through the reconciliation project, we have developed the data and process knowledge critical to moving forward with automation. All reconciliation elements are now supported with detailed documentation. Strong processing controls and numerous transaction verifications have been developed and implemented to ensure all data received from all sources is complete and accurate.

With this understanding of all the banking data and processes, we are currently conducting an extensive, detailed review of the previously purchased system (Trintech) to determine whether or not it will meet our needs. Our review to date is revealing that Trintech will most likely not meet our reconciliation and process needs. It may be able to perform a portion of the basic functions such as matching deposits and paid checks, but we don't believe it will be able to accomplish the automation of the full reconciliation process as we now understand it. We will formally state our position with regard to Trintech once we have finished our review.

Given the information we have gathered to date, we have included funds in the FY 07 budget for a consultant to utilize the information from our review of Trintech's capabilities and prepare a detailed requirement analysis for an automated system.

Once the full documented requirement analysis has been delivered, we will move forward following the State of Maryland's Systems Development Life Cycle (SDLC) methodology, promulgated by the State's CIO, to develop a comprehensive bank reconciliation and processing system that meets the needs of the Office, and ultimately the State of Maryland. The Banking and Information Technology Divisions will work closely together to ensure the direction taken is in agreement with the strategic plan, performance measures, and business needs of the State Treasurer's Office. All ten phases of the SDLC will be addressed by the STO project team which will include Banking, IT, Executive Management and interested parties from State agencies.

It is anticipated that both Banking and IT contractual services will be needed for an extended period of time (most likely over a year) so we may fulfill the requirements of the SDLC. These services include requirements analysis, design, development, integration and testing, and implementation. Plans and budgets will be developed as the automation project becomes more defined.

Currently there are three vacant positions in IT filled with contractual programmers. Our intention is to maintain these as contractual during this transition period and then fill them with permanent staff after we select our automated system, so as to ensure the IT skills match system needs going forward.

As with any successful system development and implementation and as recommended by the SDLC, a dedicated team is necessary to minimize interruption to the current environment and to deliver a quality system on time. To this end, we will ensure the continuity of our detailed, accurate, and fully documented reconciliation.

***2) DLS recommends that the Treasurer's Office continue to seek full SITF funding to the level recommended by the actuary. DLS also recommends that the Treasurer continue to implement risk management strategies to reduce the incident of claim losses.***

The Treasurer's Office continues to be concerned by the continuing unfunded liability in the State Insurance Trust Fund. This unfunded liability has grown significantly over the past several years as a result of: 1) the removal of funds through the BRFA; 2) increases in unanticipated catastrophic losses; 3) increases in commercial premiums as a result of the terrorist attacks of September 11, 2001; and 4) increased claims payments which have exceeded premiums collected.

As would any insurance company or organization, we will continue to recommend premium levels to the Department of Budget and Management (DBM) that would be sufficient to return and maintain the State Insurance Trust Fund at the full funding level recommended by the actuary. The most prudent way to eliminate the unfunded liability and return the fund to an actuarially sound balance is through adequate premiums charges. However, at the request of DBM and in addition to our full funding recommendations, the Treasurer's Office also supplies DBM with a 'minimum premium' to be collected, the amount projected to cover the anticipated claims required to be funded in the next fiscal year, but not address the unfunded actuarial deficit, including 'out-year' costs of claims incurred in FY 07. While the Treasurer's Office makes premium level recommendations to DBM, it remains the prerogative and responsibility of DBM to decide what appropriations for premiums to include in the agencies' operating budgets.

## **Risk Management and Loss Prevention**

The Insurance Division's loss prevention efforts are directed at promoting risk management activities within State agencies. These loss prevention efforts include sharing existing loss prevention information and sharing risk management resources and capabilities among State agencies. Selective loss prevention support needs of the University System and other State agencies have been reviewed, and we are enhancing inter-agency cooperation. The Insurance Division is represented on the State Employees Risk Management Administration's Agency Risk Management Advisory Council, the University System's Risk Management committees, and the Maryland Emergency Management Agency's (MEMA) Disaster Mitigation Risk Management team.

The Insurance Division's Loss Prevention Unit is responsible for identifying potential major causes of loss and recommending changes which will help eliminate or decrease claims in State agencies. We are also

working closely with State agencies to evaluate safety programs and making recommendations for improvement. State agencies with effective loss control programs should have measurable SITF and commercial insurance cost savings.

As a direct result of the loss prevention partnership between the STO and the Maryland Emergency Management Agency; the University of Maryland College Park, University of Maryland Eastern Shore, Salisbury University and the Department of Natural Resources will be applying for FEMA grant money totaling well over \$200,000 to create feasibility plans to mitigate flood losses by diverting storm water runoff and river overflows. The Insurance Division and MEMA met jointly with these agencies to help determine flood mitigation action plan strategies and review property loss exposures in flood prone areas.

Additionally, as a result of the loss prevention teamwork between the STO and the Office of the Fire Marshal, sprinkler system deficiencies at the Maryland Port Administration's (MPA) paper storage sheds were identified and evaluated. MPA, working cooperatively with the Office of the Fire Marshal, recently allocated \$6.2 million dollars, over three years starting in FY 07, to fund a major upgrade to its paper storage shed sprinkler systems. The sprinkler system upgrades will allow the storage buildings to meet current fire and life safety codes and satisfy the economic growth requirements of an important MPA tenant.

The Loss Prevention Manager recently completed a comprehensive SITF loss history analysis and visited a number of University System staff, State agency risk managers, and facility operation chiefs. Agencies with adverse loss history received multiple visits to assist them in creating loss reduction action plans targeting at least one source of preventable loss for each agency. The STO will monitor all these efforts and their results and build upon those findings.

Property losses continue to be a significant issue. For fiscal years 2000 through 2005, the SITF incurred \$21.7 million in paid or reserved property claims. Property loss prevention efforts include the identification of potential fire and life safety compliance problems so that effective corrective action can be taken as quickly as possible. The State Fire Marshal and the excess property insurance company notify the Insurance Division as soon as a State owned building fails a fire and life safety or engineering safety inspection or a sprinkler system fails to meet testing or occupancy fire load standards. The Boiler & Machinery insurance company sends the Insurance Division immediate notice if a boiler fails to meet State inspection requirements. Poorly functioning boilers have caused pipes to freeze with resulting water damage to buildings and contents. Water damage is one of the leading perils of property damage claims. At the direction of the Insurance Division, supplemental in-depth engineering and life safety inspections are performed on a designated number of State owned properties each year to comply with insurance company underwriting requirements. These in depth inspections provide another source of professional information regarding the fire and life safety compliance level of State owned property.

The Insurance Division will continue to conduct regular training and education seminars for State agency insurance coordinators. This improves knowledge of claim reporting requirements and expedites the claims adjustment process resulting in lower claim payments. We are developing a Risk Management and Loss Prevention Bulletin Board that will be placed on our web site to give State agencies a greater awareness of current best practices to improve loss control and prevention. We also will continue to provide additional focused training and education for our claim adjusting staff on principles of investigation, law of torts, tort defenses, evidence, evaluating medical damages, and settlement negotiating techniques. This will allow our adjustors to be better equipped to negotiate settlements.

In September, 2005, the Department of Budget and Management approved the STO's request for a specific discretionary authority regarding COMAR regulation 17.01.01.04 H. The authorization allows the STO to use inter-company arbitration on claims with a value up to \$5,000. The claims staff will now be able to employ an additional method of recovering monies in disputed liability claims between the State and a third party insurance carrier without the cost of litigation. The use of this authority will be carefully monitored and documented.

While the Loss Prevention program is new for the Insurance Division, as the program develops and we gain practical field loss prevention measurement experience, we will be looking into additional ways to achieve further loss cost savings. This will include strengthening our functional partnership with the Office of the State Fire Marshal to measurably reduce State Insurance Trust Fund property losses while also protecting the safety of State employees and the general public. Finally, we are also pressing for the increased use of new technologies to prevent loss, such as recommending the use of water flow alarms in buildings with research or medical laboratories and the use of infrared thermographic imaging cameras to inspect high voltage electrical systems in State buildings.

- 3) *DLS recommends that the funding and PINs for the 4 new positions be deleted; and instead, the Treasurer's Office should work to have existing long-term vacant positions reclassified and filled to meet the needs of the Banking Division's personnel requirements.*

**The 4 new PINs that have been requested are necessary for the State to maintain the current reformed reconciliation process and structure. This comprehensive and accurate system, which took \$1 million and over 11 contractual workers to establish, cannot be maintained without necessary staff. The vacancies that currently exist within the agency are also necessary for the continuing operations of the Office.** Several of the positions have been recently vacated, several are in recruitment process, one has been filled, and the remainder have been held vacant intentionally in an effort to manage efficiently within our budget.

We currently have 3 long term vacancies all in our IT Department. These positions have been held vacant until a decision is made on an automated reconciliation system. We have used the money to pay contractual RPG III programmers who originally wrote the code on the current computer system that banking is utilizing for reconciliation. We plan to fill the positions with permanent staff after we select our automated system. It is essential to maintain these slots as contractual during the transition to a new automated system and to ensure the IT skills of the permanent employees match system needs going forward. If these positions and funds were moved out of IT, the State Treasurer's Office could not function.

We have one Accounting Manager for the agency and that position was vacated 12/1/05. The employee was suffering with a long-term illness and just recently applied for and received a disability retirement. Recruitment has begun on this position and we anticipate it being filled within the next several weeks.

We have one Procurement Officer for the Agency and that position is in the process of being reclassified. Once the reclassification is complete, recruitment will begin.

Currently, the major duties of the Accounting Manager and Procurement Officer are being handled by the Director of Operations for the Agency with the remainder of the duties being done as time allows by others or not at all. This situation cannot continue.



A position of Insurance Claims Adjustor was recently filled and the paperwork has been submitted to DBM.

The Deputy Director of Insurance was vacated 12/1/05 and we've promoted our Risk Manager to the Deputy position and are now actively recruiting for a new Risk Manager. We will conclude interviews next week and anticipate a selection shortly thereafter.

We have combined duties from two administrative positions to allow us to transfer a vacant position to our Debt Management Division which is in need of a financial analyst. With the recent hiring of a new Debt Management Director, recruitment will now begin for a financial analyst.

The Deputy Director of Banking Services is currently vacant due to the fact that the top candidates from the last round of interviews did not pass the background check. We have re-advertised for that position.

The final vacancy is the position recently made vacant by the promotion of the present Director of Operations. This is the slot which would be filled by a senior financial policy advisor to the Treasurer, a function that is presently only partially performed by the State's New York based financial advising consultant.

While we understand the need to keep the FTE count down, the Treasurer's Office currently has a very small staff of 55 employees. We have made every attempt to control the number of new positions we request by reassigning duties and transferring positions within the Agency. If we are not allocated an additional 4 PINs the Office's operations would be seriously hampered and the financial services we deliver to the State extremely adversely affected.

**4) *DLS recommends that the Treasurer comment on the need and justification for the position reclassifications, and any plans for additional reclassifications to the Executive Pay Plan not already listed in the fiscal 2007 budget as introduced.***

The Treasurer's Office has historically had a difficult time recruiting individuals to fill the positions of Division Directors. We reviewed the duties and responsibilities of these positions and compared them to other comparable positions in State Government. We focused on agencies such as the Comptroller whose Director's have Statewide control functions similar to the Treasurer's. In that review, we discovered that the positions within those agencies were classified within the Executive Pay Plan. We contacted DBM and worked with the Director of Personnel to review all of the Division Director positions for movement into the proper classification. After a thorough review by DBM it was determined that the duties and responsibilities of the positions showed they should be moved into the Executive Pay Plan. This recent move places all of the Division Directors and the Director of Operations into the Executive Pay Plan and the Treasurer does not anticipate the reclass of any additional positions at this time.

With the move of senior staff into the Executive Pay Plan the Treasurer realizes an added benefit. The Directors will no longer receive a routine increment each year; any increase in salary will be based upon performance and meeting appropriate goals and objectives.

